IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 23

FRIBOURG NAVIGATION COMPANY, INC., *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF FOR THE AMERICAN AUTOMOTIVE LEASING ASSOCIATION AS AMICUS CURIAE

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THE INTEREST OF THE AMERICAN AUTOMOTIVE LEASING ASSOCIATION

This brief as *amicus curiae* is submitted on behalf of the American Automotive Leasing Association with the written consent of both parties. The letters consenting to the filing of the brief have been filed in the office of the Clerk.

The American Automotive Leasing Association was organized on November 25, 1955 as a non-profit cor-

poration under the laws of the State of Illinois. It is a trade association composed of long-term automotive leasing companies engaged in the business of leasing automobiles to commercial and industrial lessees for periods of one year or more. A recent survey of the Association membership disclosed that the member companies had on lease approximately 260,000 vehicles representing an investment of approximately $700,000,000.00.

Automotive leasing companies purchase vehicles new from automobile dealers. These new vehicles are then leased in volume to commercial and industrial lessees who operate them in their businesses. Upon the expiration of the lease periods, the vehicles are returned to the lessors, who generally dispose of them at wholesale, sometimes to used car dealers, sometimes at auctions. Since most of the member companies of the Association have lessees in many states, the cars are not usually returned to the home offices of the lessors for disposition, but are sold, most of the time, at or near the places where the lessees had been operating them. Vehicles are not leased a second time as used cars.

While the vehicles are on lease, they are, for tax purposes, property used in the business of the lessor (see *Hillard* v. *Commissioner,* 281 F.2d 279 (C.A. 5); *Philber Equipment Corp.* v. *Commissioner,* 237 F.2d 129 (C.A. 3)), and a depreciation deduction for each vehicle is taken pursuant to section 167 of the Internal Revenue Code of 1954. When the vehicles are disposed of at the termination of the leases, the gains realized or losses sustained are handled in accordance with the provisions of section 1231 of the Code—any gains realized over the depreciated basis of the vehicles

at the time of sale being entitled to capital gains treatment.[1]

It is thus apparent that the resolution of the issue involved in this case—which concerns the validity of the Commissioner's disallowance of the deduction for depreciation during the year in which an asset is sold and while it is still in use in the taxpayer's business—is of vital interest to the members of the American Automotive Leasing Association. The case of *The Motorlease Corporation* v. *United States* (No. 24, Oct. Term, 1965), pending in this Court on petition for a writ of certiorari, which was decided by a different panel of the court below on the same day as the decision in the instant case "on the authority of, and for the reasons given" in the opinion in the instant case (334 F.2d 617, 618), involves the application to automotive leasing companies of the basic legal principles at issue in this case. Petitioner in *The Motorlease Corporation* case is a member of the American Automotive Leasing Association, and as the petition for a writ of certiorari in that case points out (Pet. p. 21), many automotive leasing companies have cases pending within the Internal Revenue Service involving the same issue. The Association appeared *amicus curiae* in the *Motorlease* litigation in both the District Court for the District of Connecticut and in the court below.

This brief on behalf of the American Automotive Leasing Association urges rejection of the principles

[1] This, of course, relates only to dispositions in years prior to taxable years beginning after December 31, 1962, which is the effective date of section 13 of the Revenue Act of 1962 (P.L. 87-834, 76 stat. 960) adding new section 1245 to the Internal Revenue Code of 1954.

adopted by the court below in this case and in *Motorlease* for reasons which will be hereinafter set forth in detail.

STATUTE AND REGULATIONS INVOLVED

Section 167 of the Internal Revenue Code of 1954 and the pertinent provisions of the depreciation regulations issued thereunder are set forth in Appendix A, *infra,* pp. 1a to 7a.

SUMMARY OF ARGUMENT

A. The Commissioner of Internal Revenue may not adopt a rule of law disallowing a taxpayer's otherwise reasonable claim for a depreciation deduction for the year in which a depreciable asset is disposed of, solely because the asset is sold for more than its adjusted basis. Section 167 of the Internal Revenue Code of 1954 affords a taxpayer a "reasonable allowance" as a "depreciation deduction" from income, in order to return to him, tax free, the approximate cost of the use of an asset in his trade or business. Further, section 1231 of the Code provides that, upon the sale of depreciable property used in a taxpayer's business for more than six months, the excess of selling price over the depreciated basis of the asset shall be treated, for tax purposes, on a capital gains basis. There is nothing in the statute which requires or suggests any different accounting for depreciation for the year in which an asset is sold.

The Commissioner's regulations, issued pursuant to section 167, set forth in detail how the "reasonable allowance" for depreciation is to be established by the taxpayer. The taxpayer first *estimates* the period over which the asset may reasonably be expected to be

useful to him in his trade or business—the period of useful life. He then *estimates* the salvage value of the asset—an estimate of the amount which will be realizable upon sale of the asset at the end of its estimated useful life. Estimated salvage value, it should be noted, is not the selling price. And, finally, he establishes, as the "reasonable allowance" for depreciation, the cost of the asset less its *estimated* salvage value, to be spread over its estimated useful life. The regulations provide further that depreciation begins when an asset is placed in service and ends when the asset is retired from service. The limit below which an asset may not be depreciated is specifically stated to be the reasonably estimated salvage value and not the amount received upon the sale of the asset, as the Commissioner now contends.

The regulations provide further that the estimate of salvage value is not to be changed because of a change in price levels; and depreciation is to continue at the reasonable rate established, with any gains or losses arising upon the sale of the asset to be accounted for in accordance with sections 1002, 1231 and other provisions of the Code dealing with gains or losses upon disposition of property.

There is, thus, no provision in the regulations which authorizes the Commissioner to disturb, in the year of sale, a concededly reasonable depreciation plan simply because an asset is disposed of for more than its depreciated basis. Indeed, the Commissioner's own regulations deny him this authority.

B. The authority claimed by the Commissioner to disallow a reasonable deduction for depreciation for the year of sale solely because an asset is sold for more than its depreciated basis is in conflict with the prin-

ciples affirmed by this Court in *Massey Motors Inc.* v. *United States* and *Commissioner* v. *Evans,* 364 U.S. 92. In those cases, this Court pointed out that the Congress intended a taxpayer to recover, under the allowance for depreciation, the cost of the asset less its *estimated* salvage value. "This requires that the useful life of the asset be *related* to the period for which it may *reasonably* be expected to be employed in the taxpayer's business. Likewise, salvage value must include *estimated* resale or second-hand value." 364 U.S. at 107 (Italics supplied). The Court specifically recognized that any gains realized upon the sale of depreciable assets were treated as capital gains. 364 U.S. at 97. In *Evans,* depreciation deductions during the year of sale were permitted down to *estimated* salvage value and below the actual selling price, and capital gains were thereby created and permitted during the year of sale. Indeed, the arguments made by the Commissioner himself in *Massey Motors* and *Evans* were inconsistent with the position he now asserts here.

Neither panel of the court below even referred to this Court's decision in *Massey Motors* and *Evans,* although many other courts have relied upon it in rejecting the Commissioner's contention.

In any event, apart from the decisions below and a decision of the Federal District Court for the Eastern District of Tennessee, every court which has considered the Commissioner's contention has now rejected it. The decision in *Cohn* v. *United States,* 259 F. 2d 371 (C.A. 6), relied on by the Commissioner, has not persuaded other courts to the Commissioner's point of view, and that case has been either distinguished on its facts or criticized as wrongly decided. Moreover, the Commissioner's contention has been widely criticized by the writers.

C. The Commissioner's contention violates basic accounting principles. It is the basic purpose of depreciation accounting to make a meaningful allocation of the cost of the use of an asset—the cost less its estimated salvage value—to the tax periods benefited by the use of the asset. Such an allocation is essential in order to determine net income accurately for any given period, and it is accepted accounting practice to allocate the cost less estimated salvage value over the entire period of estimated useful life. As a matter of accounting practice, appreciation in the value of an asset is not offset against depreciation. These well-settled principles were affirmed in the earliest decisions of the Board of Tax Appeals which required that a depreciation deduction be taken until the date of sale of an asset in order to determine the basis of the property for purposes of establishing gain or loss on disposition. There was not the slightest suggestion that depreciation could not or should not be taken in the year of sale if to do so would reduce the basis below selling price. And in *United States* v. *Ludey,* 274 U.S. 295, this Court held that depreciation must be deducted up to the date of sale for purpose of establishing gain.

The Commissioner's arbitrary rule of law excludes the last year of an asset's use from the period of depreciation, notwithstanding that during that year the asset is in use in the taxpayer's business, represents a cost of doing business during that year, as in any other year, and contributes to the receipt of income during that year. This arbitrary rule violates the basic principle that depreciation accounting is intended to allocate meaningfully the cost of an asset's use to all periods to which such use contributes and, additionally, it conflicts with the Commissioner's own require-

ment that depreciation shall end when an asset is *retired* from service.

The Commissioner's rule results in a distortion of income by understating income for years prior to the year of sale and overstating income for the year of sale. In addition, the Commissioner's contention would make depreciation accounting, and resulting income statements, depend on wholly artificial and arbitrary circumstances, for a taxpayer can avoid the impact of the rule by merely holding an asset until shortly after the beginning of a new tax year and then disposing of it. In these cases, every penny of disallowed depreciation could have been retained, on the Commissioner's own theory, if the assets were held for short periods into new tax years. The Commissioner's rule of law not only fails to further the integrity of periodic income statements, which is the real purpose of depreciation accounting, but, additionally, it penalizes the careful taxpayer and invites abuse of the depreciation concept by providing an incentive to take larger depreciation deductions during the years prior to the year of sale, thereby creating capital gains which the Commissioner's theory permits to be retained. A more strained and perverse interpretation of sound depreciation practice is difficult to imagine.

D. In 1942, the Congress added section 117(j) to the Internal Revenue Code of 1939 providing for the capital gains treatment of gains realized upon disposition of depreciable assets. This provision was reenacted without substantive change as section 1231 of the Internal Revenue Code of 1954. As we have shown, it was accepted accounting practice, confirmed by the earliest decisions of the Board of Tax Appeals and decisions of this Court, for depreciation to be taken for

the entire period of an asset's use up to the date of its sale, in order to establish the gain or loss upon sale. There is nothing in section 117(j) or its history to suggest that the Congress intended to include within the scope of section 117(j) only those gains developed by depreciation deductions in the years prior to the year of sale. There is no suggestion of any purpose to depart from accepted practice.

Thereafter, on many occasions in connection with deliberations on a variety of legislative proposals, the Congress was warned of the revenue losses sustained by the Treasury because of the capital gains rates applicable to dispositions of depreciable assets. Neither in the warnings nor in the Congressional statements was there even a suggestion that what was involved was only those capital gains that might be developed by deductions for depreciation prior to the year of sale. On the contrary, it is clear that the Congress considered the problem in the light of revenue losses resulting from the applicability of capital gains rates to gains resulting generally from the sale of depreciable assets where deductions had been taken up to the date of sale in the year of sale. Nevertheless, the Congress refused to amend the law in this regard until 1962 when section 1245 was added to the Internal Revenue Code of 1954, treating as ordinary income the gain realized on the sale of depreciable property, during taxable years after December 31, 1962, to the extent of depreciation taken prior to December 31, 1961. This legislation was not retroactive. This course of activity, or inactivity, by the Congress makes it plain that the Commissioner has attempted, by his ruling in these cases, to accomplish what the Congress had refused to permit for so long a period of time.

ARGUMENT

WHERE A DEPRECIATION PLAN FOR A DEPRECIABLE ASSET IS ADOPTED BY A TAXPAYER IN ACCORDANCE WITH THE PROVISIONS OF SECTION 167 OF THE INTERNAL REVENUE CODE OF 1954 AND THE COMMISSIONER'S REGULATIONS, AND IS CONCEDED TO BE REASONABLE, THE TAXPAYER IS ENTITLED TO A DEPRECIATION DEDUCTION FOR SUCH ASSET FOR THE YEAR IN WHICH IT IS SOLD FOR MORE THAN ITS ADJUSTED BASIS.

The single legal issue involved in this case concerns the right of a taxpayer to claim a depreciation deduction for a depreciable asset during the year in which he disposes of the asset at a price which exceeds its adjusted basis. The Commissioner contends that, during the year of sale of the asset, that part of the claim for depreciation which would reduce its adjusted basis below the selling price must be disallowed and, further, that if the adjusted basis of the asset at the beginning of the year of sale was already below the ultimate selling price, then all depreciation claimed during the year of sale of the asset must be disallowed.[2] The Commissioner's argument is quite simple, and, indeed, it has a "beguiling appeal" (*Macabe Co. Inc. et al.* v. *Commissioner,* 42 T.C. 1105, 1109). The purpose of

[2] In the instant case, since the vessel was sold for more than its adjusted basis (book value) at the beginning of the year of sale, all depreciation during the year of sale was disallowed. *Fribourg Navigation Co.* v. *Commissioner,* 335 F.2d 15, 16 (C.A. 2). In the *Motorlease* case, some of the vehicles were sold for less than their adjusted basis at the beginning of the year of sale, but for more than their adjusted basis at the time of sale, and in those instances there was disallowed that part of the depreciation claimed during the year of sale which would reduce the adjusted basis below the selling price. See *United States* v. *The Motorlease Corporation,* 334 F.2d 617, 618 (C.A. 2). Hereinafter, when reference is made to the "disallowance" of depreciation during the year of sale, we refer to either the partial or total disallowance, depending on the adjusted basis of the asset at the beginning of the year.

the depreciation allowance, the argument goes, is to return to the taxpayer, tax-free, the net cost of using the asset in his business. When the asset is sold and its selling price becomes known, the net cost to the taxpayer of the use of the asset (the orginal cost less the known selling price) also becomes known, and any depreciation deduction, during the year of sale, which would reduce the adjusted basis below the actual selling price would return to the taxpayer an amount in excess of his net cost and must, therefore, be disallowed as beyond the proper scope of the depreciation allowance. In the Commissioner's view, it is immaterial that the taxpayer's depreciation plan had been approved by him, in advance, as in this case (335 F.2d 15, 16, 19), or is conceded to be reasonable in every regard, as in the *Motorlease* case (334 F.2d 617, 619), and it is similarly immaterial that the claimed depreciation may reduce the adjusted basis to only a few cents below the selling price.[3] The sole determining factor, in the Commissioner's view, is the fact that the asset is sold at a price which exceeds its adjusted basis.

We contend that the Commissioner's position is incorrect. It is our contention that, under section 167 of the Internal Revenue Code and the pertinent regulations issued pursuant thereto, a taxpayer must estab-

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[3] In the *Motorlease* case, for example, District Judge Blumenfeld pointed out that "in four specific instances in this case, the commissioner disallowed depreciation respectively of \$0.03, \$2.82, \$2.33, and \$4.70" *The Motorlease Corporation* v. *United States*, 215 F.Supp. 356, 361. (D.Conn.) In addition, in *Motorlease*, the taxpayer's depreciation plan resulted in losses being sustained upon the disposition of approximately one-third of the vehicles during the years involved. The details are set forth in the Petition for a Writ of Certiorari in that case (No. 24, Oct. Term, 1965), p. 4, n. 3.

lish a reasonable plan of depreciation for a depreciable asset designed to provide the "reasonable allowance" provided for in section 167. Having done that, the taxpayer is entitled to depreciate the asset from the time it is put into service in his business until it is disposed of.[4] So long as there is no challenge to the reasonableness of the plan, and there has been none either in this case or in the *Motorlease* case—the mere fact that the asset is sold for more than its adjusted basis affords no occasion to disallow year-of-sale depreciation. Any excess of sales price over adjusted basis in such a case is properly treated as a gain realized upon the sale of a depreciable asset and taxable as such at whatever rate may be applicable. This view, we contend, is in accord with basic and well-established principles of depreciation accounting; it results in none of the completely absurd consequences which, as we shall show, follow from the Commissioner's position; and, we submit, this view is precisely what the Commissioner's own regulations require.

A. The Commissioner's Denial of the Claimed Depreciation Deduction Is In Conflict With the Statute and the Commissioner's Own Regulations.

1. *The statute*—Section 167 of the Internal Revenue Code of 1954 permits a taxpayer to deduct from his income a "reasonable allowance" as a "depreciation deduction" for the property used in his trade or business. The provision, it should be emphasized, is for a "reasonable allowance"; it does not provide for a deduction of a specific amount limited to the original cost of an asset, less what is actually received upon its

[4] The asset, however, may not be depreciated below a reasonably estimated salvage value, a figure not to be confused with the actual ultimate selling price on disposition. See *infra*, pp. 17-18, 22.

ultimate sale.[5] The purpose of this "reasonable allowance" as a depreciation deduction is "to *approximate* and *reflect* the financial consequences to the taxpayer of the subtle effects of time and use on the value of his capital assets." *Detroit Edison Co.* v. *Commissioner,* 319 U.S. 98, 101 (Italics supplied). Mr. Justice Brandeis has stated that the depreciation allowance "is a bookkeeping device introduced in the exercise of practical judgment to serve three purposes. It preserves the integrity of the investment. * * * It serves to distribute equitably throughout the several years of service life the only expense of plant retirement which is capable of *reasonable ascertainment*—the known cost less the *estimated salvage value.* And it enables those interested, through applying that plan of distribution, to ascertain, *as nearly as is possible,* the actual financial *results of the year's operations.*"[6] (Italics

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[5] The deduction authorized has always been for a "reasonable allowance". This has been the definition since as far back as 1909. See section 23(1) of the Internal Revenue Code of 1939, 53 stat. 14; section 23(1) of the Revenue Act of 1938, 52 stat. 462; section 23(1) of the Revenue Act of 1936, 49 stat. 1660; section 23(1) of the Revenue Act of 1934, 48 stat. 689; section 23(k) of the Revenue Act of 1932, 47 stat. 181; section 23(k) of the Revenue Act of 1928, 45 stat. 800; sections 214(a)(8) and 234(a)7 of the Revenue Acts of 1926, 1924, 1921, and 1918, 44 stat. 27, 42; 43 stat. 270, 284; 42 stat. 240, 255; 40 stat. 1067, 1078; sections 5, Seventh and 12(a), Second, of the Revenue Act of 1916, 39 stat. 759, 768; sections II, B and II, G(b) of the Revenue Act of 1913, 38 stat. 167, 172; and section 38, Second, of the Special Corporate Excise Tax of August 5, 1909, 36 stat. 113.

[6] Mr. Justice Brandeis, dissenting in *United Railways & Electric Co.* v. *West,* 280 U.S. 234, 264. See *Federal Power Commission* v. *Hope Natural Gas Co.,* 320 U.S. 591, 606-607, disapproving the holding in the *West* case and referring with approval to Mr. Justice Brandeis's statement.

supplied.) This view is reflected in Mr. Justice Clark's more recent statement that "it is the primary purpose of depreciation accounting to further the integrity of *periodic* income statements by making a meaningful allocation of the cost entailed in the use (excluding the maintenance expense) of the asset *to the periods to which it contributes*". *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 104 (Italics supplied).

Since the depreciation deduction is a "bookkeeping device" which is entered currently in a taxpayer's accounts during the period that property is being used in the business in order to "reflect and approximate" the cost to the taxpayer of the use of that asset, and at a time when the actual net cost of its use cannot be known because it is not known what, if anything, might be recovered for that asset when it is ultimately disposed of, it becomes clear why the Congress has defined the deduction only as a "reasonable allowance" and has never changed the definition. To be sure, after the asset is finally disposed of, the specific amount recovered on its sale is ascertained, and the precise net cost to the taxpayer of the use of the asset over the entire period of its use also becomes known. And the Congress has dealt specifically with that event. It has provided specifically in section 1231 of the Internal Revenue Code of 1954 that, upon the sale of depreciable property used in a taxpayer's trade or business for more than six months, the excess of the selling price over the depreciated basis of the asset at the time of the sale shall be treated, for tax purposes, on a capital gain basis. To the extent that the asset is disposed of for less than its depreciated basis, the provisions of the Internal Code dealing with gains and losses on disposition of property apply. See Subchapter O of the Internal Revenue Code of 1954.

There is nothing whatsoever in the statutory provision for the "reasonable allowance" for depreciation which requires or in any way suggests a different handling or a different definition of depreciation for the year of sale of an asset. It would have been quite simple for the Congress to have added to section 167 a proviso that, during the year in which an asset is sold, no deduction for depreciation would be permissible after the total deductions equalled the original cost less the actual amount received on the sale of the asset. See Judge Moore, dissenting below, *Fribourg Navigation Co.* v. *Commissioner,* 335 F.2d at 20. But, as already noted, the statute does no such thing. Insofar as depreciation is concerned, it is treated no differently in the year of sale than in any other year. The consequences of the sale are reflected in the provisions of Subchapter O and of section 1231 of the Revenue Code of 1954 treating with the gains realized and losses sustained on the disposition of the asset.[7]

2. *The regulations*—On June 12, 1956, the Commissioner published in the Federal Register (21 F.R. 3985 *et seq*) the final regulations setting forth in detail how a taxpayer must establish the "reasonable allowance" for depreciation provided for in section 167 of the Internal Revenue Code (T.D. 6182, 26 C.F.R. 1.167(a) *et seq.*).[8] This was almost two years after the enactment of the Code on August 16, 1954. An examination

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[7] No change in principle has been made by the additions of section 1245 in 1962 and section 1250 in 1964 to the Internal Revenue Code of 1954. Only the rate of tax on certain portions of such gains has been changed.

[8] Hereafter, we shall refer to the regulations only by their section numbers, since these are the same as the section references in 26 C.F.R.

of these regulations, we submit, makes it abundantly clear that the Commissioner has failed to abide by his own regulations (see *Service* v. *Dulles,* 354 U.S. 363) and that both majority panels of the court below were in error when they approved of the Commissioner's disallowance of year-of-sale depreciation.

Section 1.167(a)-1(a) of the regulations defines the reasonable allowance for depreciation as the "amount which should be set aside for the taxable year in accordance with a reasonably consistent plan * * *, so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property." "Salvage value" is defined, not, as the Commissioner assumes, as the amount actually received upon the sale of an asset, but as "the amount (determined at the time of acquisition) which is *estimated will be realizable* upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer". Section 1.167(a)-1(c). It is further provided that the *"estimated* useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset *may reasonably be expected to be useful to the taxpayer in his trade or business."* Sec. 1.167(a)-1(b). (Italics supplied) See *Commissioner* v. *Evans* and *Massey Motors, Inc.* v. *United States,* 364 U.S. 92[*] and *Hertz Corp.* v. *United States,* 364 U.S. 122. And section 1.167(a)-10(b) provides that "The period for depreciation of an asset

[*] The *Evans* and *Massey Motors* cases were consolidated for argument in this Court. One opinion, 364 U.S. 92, was rendered for both cases, but the facts in each case were separately stated.

shall begin when the asset is placed in service and shall end when the asset is *retired* from service." (Italics supplied).

Thus, it is apparent that a taxpayer, in establishing the "reasonable allowance" for depreciation, must first *estimate* the period of the useful life of the asset in his business, must then estimate the salvage value of the asset as of the end of that period of useful life, and must then take, as a depreciation allowance, the cost less the *estimated* salvage value spread over the *estimated* useful life of the property in the business. The resulting depreciation allowance, which is based on two *estimated* figures, is itself, therefore, an *estimated* figure, determined at the beginning of the period of an asset's use; it is not, nor can it be, a precise figure which becomes known only after the sale of an asset, when both the precise period of its actual useful life and the precise amount of recovery upon its disposition become known.

It should be noted, moreover, that these provisions recognize that, although the recovery of cost of the use of an asset, tax free, may very well be the ultimate ideal to be achieved (see ***Massey Motors, Inc.*** v. ***United States,*** 364 U.S. 92, 96, "It was the design of the Congress to permit the taxpayer to recover, tax free, the total cost to him of such capital assets * * *"), this ideal would be accomplished only in the rare case. The regulations do not provide that the aggregate of the depreciation deductions plus the amount received upon disposition of an asset shall equal the cost of the asset which is to be returned tax-free. Instead, it is the sum of the depreciation deductions plus the amount "which is estimated will be realizable upon sale or other disposition of an asset" (see sections 1.167(a)-1(a), 1.167

(a)-1(c)) which must equal the original cost. In short, the regulations provide for a formula whose elements total the original cost of the asset to be returned tax free, but these elements are necessarily based on estimates; and, to the extent that the estimates are reasonable, the purpose of the statute and the regulations has been achieved.

It is the failure of the Commissioner and of the court below to appreciate what has been provided for in the Commissioner's own regulations that has resulted in the error of the court below. Just as with the statute, itself, it would have been quite simple for the Commissioner to have provided in his regulations that, during the year in which an asset is disposed of, no deduction for depreciation would be permissible after the total deductions equalled the original cost less the actual amount received on the sale of the asset.[10] But the fact is that the regulations do not so provide, and we submit, they do not so provide because at the time they were promulgated, there was an appreciation of the fact that it was a "reasonable allowance" that was being provided for rather than a rigid figure of original cost less actual recovery on sale.

Other provisions of the regulations support our view. In order to assure that a depreciation plan shall continue to be a reasonable one throughout the period of use of an asset and that the total deductions for the entire period of use shall achieve the statutory purpose of providing a "reasonable allowance," the regulations

[10] We, of course, do not concede that this would have been permissible under the statute. The Commissioner has, in effect attempted to do this in Rev.Rul. 62-92, 1962-1 Cum.Bull. 29, issued after the litigation in these cases was underway.

set forth rules for modifying depreciation plans when conditions change during the period of an asset's use. But, as we shall show, these provisions for modification authorize or require changes only in very limited circumstances. The regulations provide, in section 1.167(a)-1(b), for the modification of the "estimated *remaining* useful life" by reason of changed conditions known to exist at the end of a taxable year. "However, estimated *remaining* useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination." Section 1.167(a)-1(c) provides further, moreover, that the estimate of salvage value "shall *not* be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section, salvage value may be redetermined based upon facts known at the time of such redetermination of useful life." (Italics supplied).

These provisions, we submit, emphasize the design of the regulations to accomplish the statutory purpose of providing for a "reasonable allowance" for depreciation over the years of an asset's use in the business; they foreclose, we submit, the Commissioner's contention, adopted by the court below, that the precise figure of cost less actual recovery on disposition of an asset is the total amount to be allowed. These provisions specifically instruct a taxpayer that a change in the price level of an asset during the course of its use, without more, should be disregarded insofar as the original salvage estimate and the depreciation allowance is concerned. Depreciation is to continue at the same rate quite apart from the rise in value of the

asset, and any gains or losses upon the ultimate disposition of the asset are made "subject to the provisions of sections 1002, 1231, and other applicable provisions of law" dealing with gains and losses on disposition of property. Sections 1.167(a)-8(a)(1). It is only when the estimated *remaining* useful life is changed that the estimated salvage value is to be revised, and the *remaining* useful life is subject to redetermination only if the change is "significant" and there is a "clear and convincing" basis therefor. See *Massey Motors, Inc.* v. *United States,* 364 U.S. at 105.

These provisions, in our view, are concerned with changes in estimates required in connection with the future continued use of the property and not with the year in which the property had been disposed of, and the Government does not contend otherwise.[11] The regulations can be searched in vain for any provision either directing the taxpayer or authorizing the Commissioner, during the year of sale, to change the salvage value estimate of a concededly reasonable plan of depreciation on the sole ground that the amount recovered on the sale of the asset has exceeded the estimated salvage value. The Commissioner purports to find the authority, not in any provision of the regulations, but in the mere assertion that, after the sale, the estimates are no longer of any significance and only the sale

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[11] In the Government's brief in *United States* v. *Wyoming Builders, Inc.*, No. 7861, pending on appeal in the United States Court of Appeals for the Tenth Circuit, it is stated (p.25): "The relevant portion of Section 1.167(a)-1(c) of the Regulations, proscribing salvage changes except when in conjunction with a redetermination of useful life, refers only to changes during the holding period of the asset—not a change resulting from termination of useful life by resale."

price controls. This means, then, that during the period of use of an asset, a taxpayer must continue to disregard known increases in the value of the asset, must continue to take annual depreciation allowances which, in all probability, will exceed the difference between the original cost of the asset and its ultimate resale price, and then, in the year of sale, must suddenly refrain from taking a depreciation deduction because the resale price must then be substituted for the estimated salvage value. This, we suggest, is absurd. If, as the Commissioner contends, the real purpose of the depreciation allowance was to return to the taxpayer only the difference between original cost and ultimate resale price, we suggest that his regulations would have required periodic changes in the estimate of salvage value. This would prevent gains on disposition from piling up over the years. But, apparently, when these regulations were drafted, the Commissioner appreciated that increases in the value of an asset were to be treated as gains on disposition of property and were not to be deemed occasions for altering an otherwise reasonable depreciation formula. The change in the value of the asset was to be disregarded during the period of the asset's use, and no sensible reason has been suggested for excluding the year of sale from that period of use.[12]

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[12] Moreover, even if the provisions of sections 1.167(a)-1(b) and 1.67(a)-1(c) are deemed applicable to the year-of-sale, it is clear that they afford no support to the Commissioner's theory. His adjustment is made whenever the sales price exceeds the salvage value and is based solely on that fact—a fact which section 1.167(a)-1(c) specifically states can provide no basis for a change. And, insofar as the estimate of useful life is concerned, the Commissioner's theory makes no inquiry into whether a change is "significant" or whether there is a "clear and convincing basis" therefor.

Furthermore, when the Commissioner undertook, in his regulations, to fix the limit of the total amount of depreciation deductions permissible for an asset—and this necessarily included the year in which the asset is sold—he very carefully refrained from fixing that limit at the original cost less the amount recovered on resale. Instead, he provided that "An asset shall not be depreciated below a reasonable salvage value" (Section 1.167(a)-1(a); see also section 1.167(a)-1(c)), a limit which concededly has not been exceeded in either this case or the *Motorlease* case.[13]

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[13] In a brief filed by the American Automotive Leasing Association as *amicus curiae* in *Hillard* v. *Commissioner*, 281 F.2d 279 (C.A. 5), the Association stated its complete accord with the depreciation regulations. This brief was filed in this Court by the Government together with its own brief in *Commissioner* v. *Evans*, 364 U.S. 92, was quoted from with approval at pages 32-35 of the Government's brief, and was referred to in this Court's opinion. 364 U.S. at 105, n.6. With respect to determination of the depreciation allowance, the Association's brief in *Hillard* stated (pp. 11-12): "In order to assist its members in complying as strictly as possible with the requirements of proper depreciation practices and in making their estimates as accurate as possible, the American Automotive Leasing Association, at great expense, has retained the services of an outstanding firm of consulting economists. This firm has been making detailed and comprehensive studies for us of all the data and factors—economic and otherwise—which go into determining the wholesale price of a used vehicle at any particular period of time, and, based on these studies, has provided the Association with detailed reports prognosticating what, in its judgment, the wholesale price of a used leased vehicle would probably be at periods of one year, one year and a half, and two years after a fleet of cars had been put in leasing service by a leasing company. These reports have covered the three most popular cars in the industry, and, of course, are based upon the

In spite of the foregoing, the court below sustained the Commissioner's position on the basis of one single sentence contained in section 1.167(b)-(O)(a) of the regulations which provides that "The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made". The argument is, apparently, that since, in the court's view, "At the end of 1957 it hardly seems reasonable to claim that the value of the Feuer had declined below its adjusted basis" (335 F.2d at 18), any claim for a depreciation deduction for 1957 could hardly be reasonable. But reliance on this sentence is plainly misplaced, and, as stated by the Tax Court in *Macabe Co., Inc.* v. *Commissioner,* 42 T.C. 1105, 1114, this is "reading too much" into that one sentence.

The sentence referred to is contained in a general introductory paragraph to a section of the regulations which describes the various "Methods of computing depreciation". It follows immediately after a sentence

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best available data on probable market conditions and demand for those particular types of vehicles at those intervals of time."

"The American Automotive Leasing Association believes that it has provided its membership with the best possible tools for arriving at reasonable depreciation allowances when new fleets of vehicles are put into service. And, as prudent business men, the members exert every effort to make their estimates of useful life and salvage value as close to the subsequent facts as possible, in order to obtain the return of their capital outlay. But we respectfully suggest that if unforeseen conditions arise,—such as war, national emergencies, material shortages, periods of inflation, or large business upturns, etc.,— resulting in larger salvage recoveries than could reasonably have been anticipated, then the resulting gains on disposition may properly be retained and reported as capital gains, * * *."

which provides that, regardless of the method used in computing depreciation, deductions shall not exceed the amount necessary to recover the cost of the asset less its estimated salvage value "during the remaining useful life of the property," and it is followed by a sentence stating that claimed depreciation deductions will be changed "only where there is a clear and convincing basis for a change." There then follow, in other paragraphs, detailed descriptions and examples of the various methods of depreciation permissible under section 167 of the Internal Revenue Code.

It seems plain that the sentence relied on is merely part of a general section introducing the various reasonable methods of computing depreciation for *continued use* of depreciable property during its "remaining useful life." It does not purport to deal with the disposition of assets. In this regard, the sentence is no different from the provisions of sections 1.167(a)-1(b) and (c), already referred to, which provide for the modification of "estimated remaining useful life" on the basis of conditions known to exist at the end of a tax year, and for a modification of the salvage value estimate, based upon facts known at the time of such redetermination of the estimate of useful life. See *supra*, pp. 19 to 21.[14] It certainly is not a provision

[14] Even if this one sentence were construed to be applicable to the year of disposition, the limiting provisions of sections 1.167(a)-1(b) and (c) (see *supra* p. 21, n. 12) would still be applicable, and the mere fact that recovery on resale may have exceeded the estimated salvage would not permit or require a change in the estimate, as the Commissioner has done here, because, if the plan were reasonable, as is conceded, the excess could only have arisen because of a change in price levels. Furthermore, section 1.167(b)-(O)(a), just like section 1.167(a)-1(b), requires that the reasons for a change be "clear and convincing".

which requires the automatic disallowance of depreciation in the year of sale whenever a gain, however small, is reported. The consequences attendant upon the disposition of an asset are, as already noted, specifically set forth in another section (1.167(a)-8(a)(1)); and, where a gain is reported, that gain is not eliminated by the adjustment of depreciation, but rather it is subjected to tax under section 1231 of the Internal Revenue Code. The claimed meaning of this one sentence of section 1.167(b)-(O)(a) is so completely inconsistent with all the other provisions of the regulations that it must be rejected. See *United States* v. *S & A Company,* 338 F.2d 629, 641 (C.A. 8), pending on petition for a writ of certiorari, No. 50, this Term; *Macabe Company, Inc.* v. *Commissioner,* 42 T.C. 1105, 1114. *Wyoming Builders, Inc.* v. *United States,* 227 F.Supp. 534, 536 (D. Wyo. 1964) pending on appeal to the Tenth Circuit. Moreover, as District Judge Blumenfeld stated in *Motorlease Corporation* v. *United States,* 215 F.Supp. 356, 361, "Even if, as the commissioner urges, 'The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made', it does not automatically follow that a price received upon the sale of a depreciable automobile, somewhat greater than estimated when it was acquired fourteen months before, established that the estimate and the depreciation based upon it was unreasonable. To illustrate: in four specific instances in this case the Commissioner disallowed depreciation respectively of \$0.03, \$2.82, \$2.33 and \$4.70. The regulations do not operate to automatically convert * * * an amount estimated at the time of acquisition to the amount realised upon sale. They do not require hindsight revisions."

It is plain from the foregoing provisions of the depreciation regulations, we submit, that a reasonable plan of depreciation for an asset is not to be disturbed and discarded after the disposal of the asset simply because the selling price exceeded its adjusted basis. The regulations make crystal clear, in our view, that salvage value is not selling price and that useful life is not the actual period of use in a taxpayer's business. The depreciation allowance is statutorily defined as a "reasonable allowance"; it is based on reasonable estimates; and it is not a single fixed amount based on cost less selling price, with regular adjustments automatically required every time an asset is disposed of for more than its adjusted base, designed to equate the period of estimate useful life with the period of actual use to the day, or to equate estimate salvage value with the precise amount to the penny recovered on disposition of an asset.[15]

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[15] In his opinion in *The Motorlease Corporation* v. *United States*, 215 F.Supp. 356, 358-359, District Judge Blumenfeld refers to several additions to the regulations which appeared for the first time in the final regulations (21 F.R. 3985) and which were not present in earlier published proposals. (19 F.R. 6229, 20 F.R. 8454). These additions made clear that salvage value was an estimated amount and not resale price, and further provided specifically for the capital gains treatment of gains realized upon the sale of a depreciable asset. Judge Blumenfeld found these additions significant. With respect to the definition of "salvage value" he stated: "It would be hard to find more explicit evidence of the Treasury's opinion that salvage value must be estimated as of the time of acquisition of a depreciable asset than is revealed by these extensive additions to the originally proposed regulations which are found in it when finally adopted." 215 F.Supp. at 358. And with respect to the capital gains provisions, he stated: "There is merit to the taxpayer's argument that this constitutes an implicit recognition by the Treasury of the settled administrative practice, that where the taxpayer honestly and reasonably complies

These views as to the meaning of the regulations are no different from those expressed by the Commis-

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with the regulations, the actual sales price, may, nevertheless, yield some gain or loss which remains to be accounted for at the rates applicable to an exchange transaction." 215 F.Supp. at 359. The Tax Court has also made reference to the changes made in the regulations during the course of their adoption. *Macabe Company, Inc.* v. *Commissioner,* 42 T.C. 1105, 1112, n.12. See also *S &A Company* v. *United States,* 218 F.Supp. 677, 683 (W.Minn.).

In this connection, it is interesting to note that when the proposed depreciation regulations were published for the second time in the Federal Register as proposals (20 F.R. 8454), the American Automotive Leasing Association, in a letter to the Commissioner, dated December 10, 1955, submitted an analysis of the proposals in which it was pointed out that, under the regulations as then proposed, salvage value might be equated with the actual price recovered on the sale of an asset, with the result that depreciation allowance would be required to be adjusted after the sale. It was urged that this was a radical departure from the accepted meaning of salvage value in the past, and suggestions were made for changes in the proposals so as to remove the possibility of the interpretation referred to and to make clear that the depreciation allowance was to be based on estimates of salvage value and useful life and was not to be disturbed, if reasonable. A copy of the letter is set forth in Appendix B, *infra,* pp. 7a to 15a.

In his reply brief in the court below in the *Motorlease* case, the Commissioner asserts (p.6) that the Association letter raised objections only to *retroactive* adjustments of deductions for prior years, and that no special concern was expressed about adjustments in the year of sale. The Commissioner's point is not well-taken. It is clear that what was meant by a retroactive adjustment was an adjustment after the sale and not merely for years prior to the year of sale. Further, there was no need to single out the year of sale as a matter of special concern, because the decision in *Wier Long Leaf Lumber Co.,* 9 T.C. 990, holding that depreciation during the year of sale was not limited by the price received for automobiles used in a business, had been acquiesced in by the Commissioner. 1948—1 C.B.3. This acquiescence was not withdrawn until after this litigation was underway. 1962—1 C.B.5.

sioner to this Court in ***Massey Motors, Inc.* v. *United States*** and *Commissioner* v. *Evans*, 364 U.S. 92. In his brief in *Evans* (No. 143, October Term, 1959) the Commissioner stated (pp. 10-11): "Concededly, if taxpayer, after holding a car for a period of time and employing it in the rental business, sells that car at a gain, the gain is entitled to treatment as a capital gain." As to the limit of the total deductions for depreciation, the Commissioner stated further (p. 29):

> On the other hand, if, as the Commissioner contends, the depreciation deduction must be based upon a rate determined by the period during which the asset can reasonably be expected to be used in the taxpayer's business and a reasonable estimate of salvage value at the end of that period, *there will be no conversion of ordinary income into capital gain. Ordinary and predictable salvage value, determined as of the time that sale of the asset is contemplated, will impose a realistic ceiling upon depreciation claims.* (Italics supplied)

B. The Commissioner's Action Is in Conflict with the Principles Affirmed in the Massey Motors and Evans cases, 364 U.S. 92.

The specific question involved in the *Massey Motors* and *Evans* cases was whether, for the purpose of determining the reasonable allowance for depreciation, the useful life of a depreciable asset is the total period of physical or economic life inherent in the asset, or the period of its estimated use in the particular taxpayer's business. In concluding that the latter period was the appropriate measure, the Court stated that a taxpayer must "estimate the period the asset will be held in the business and the price that will be received for it on retirement. Of course, there is a risk of error in such

projections, but prediction is the very essence of depreciation accounting". 364 U.S. at 105.

The Court was not unaware of the fact that, upon sale of a depreciable asset, gains realized "are capital gains and incur no more than a 25% tax rate" (*Id* at 97), and it recognized that its definition of useful life would not eliminate the realization of capital gains. Its definition, the Court noted, merely represented an approach which was "far *more likely to reflect* correctly the actual cost over the years in which the asset is employed in the business." *Id* at 106 (Italics supplied.)[16]

Indeed, in the *Evans* case, the Commissioner, in disallowing the taxpayer's claimed depreciation deductions for the reason that no proper and reasonable estimates of useful life and salvage value had been made, did not undertake to equate estimated salvage value with actual sales price; nor did he disallow depreciation in the year of sale as such. Instead, he, himself, made the estimates which the taxpayer should have made in the first place; and, at a time when the vehicles in that case had already been sold for an average price of $1380.00, he estimated their reasonable salvage value at $1325.00 and allowed depreciation during the year of sale down to that estimated figure which

[16] The Court concluded that "the Congress intended that the taxpayer should, under the allowance for depreciation, recover only the cost of the asset less the *estimated* salvage, resale or second-hand value. This requires that the useful life of the asset be *related* to the period for which it may *reasonably* be expected to be employed in the taxpayer's business. Likewise, salvage value must include *estimated* resale or second-hand value". *Id.* at 107. (Italics Supplied).

was below the actual sales price, thereby permitting an average capital gain of $55.00 per vehicle.[17]

In the *Massey Motors* case, many of the vehicles involved were disposed of during the same year in which they were purchased (see Brief for the United States, No. 141, Oct. Term, 1959, pp. 4-5, fn. 2); yet the Government made no contention or suggestion that, in any event, as to those vehicles, the depreciation should be disallowed on the theory it now puts forward. The depreciation had been disallowed by the Commissioner on the ground that the vehicles were not property used in the trade or business, but were held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. *Ibid.* And when the taxpayer filed a refund suit in the District Court and obtained a ruling that its vehicles were capital assets entitled to depreciation and that its inherent life theory of useful life was proper (*Massey Motors, Inc.* v. *United States,* 156 F.Supp. 516 (S.D. Fla. 1957), the Government, in the Court of Appeals, abandoned its contention that the vehicles were ordinary stock in trade and relied solely on the contention that useful life is the estimated period of use in the particular taxpayer's business and that depreciation cannot prop-

[17] District Judge Blumenfeld in the *Motorlease* case observed (215 F.Supp. 356, 360-361): "Indeed, it is clear that the commissioner did not even argue in *Massey* for the proposal he asserts here. In calculating the taxpayer's deficiencies, he used an estimated salvage value of $1325.00 per car, rather than $1380.00, which was the actual selling price. He was not trying to eliminate all interplay between §167 and §1231". See also Circuit Judge Moore, dissenting in *Fribourg Navigation Co.* v. *Commissioner*, 335 F.2d 15, 21; *United States* v. *S & A Co.*, 338 F.2d 629, 642 (C.A. 8), now pending on petition for writ of certiorari, No. 50, this Term.

erly be determined without estimating salvage value as of the end of that estimated useful life. Brief for the United States, *supra,* pp. 5-6; *United States* v. *Massey Motors, Inc.,* 264 F.2d 552, 554 (C.A. 5).

In the Government's briefs to this Court in *Evans* and *Massey Motors,* the Commissioner properly argued that the reasonable allowance for depreciation was not intended to be a device to convert ordinary income into capital gains, and, as we have already noted, the Commissioner urged that the adoption of his definitions of useful life and salvage value, with which we agree and which have been followed by the taxpayers in this case as well as in *Motorlease,* would not result in such an improper conversion of ordinary income into capital gain since "Ordinary and predictable salvage value, determined as of the time that sale of the asset is contemplated, will impose a realistic ceiling upon depreciation claims". (*Supra,* p. 28).

Nowhere in the Commissioner's briefs in *Massey Motors* or *Evans* is there a single reference to any principle that would disallow depreciation in the year of sale when a gain is reported. The decision in *Cohn* v. *United States,* 259 F.2d 371 (C.A. 6), which apparently is relied on for the principle,[18] had been decided long before the Government's briefs were filed in *Massey Motors* and *Evans,* yet at no place in the Government's briefs is there any reliance or even reference to the *Cohn* case for the proposition now being

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[18] See Rev. Rul. 62-92, (1962-1 Cum.Bull.29).

urged here; and the *Cohn* decision is not even cited in this Court's opinion.[19]

We have no criticism of the Commissioner's contentions or arguments in *Massey Motors* and *Evans;* we are in complete agreement with them. The point is that this Court's opinion must be read in the context of the arguments that were presented to it, and, in that context, what was approved by this Court in those cases was precisely what the court below in both the *Fribourg Navigation Co.* and *Motorlease* cases disapproved. To be sure, this Court in *Massey Motors* and *Evans* did not have before it the single isolated issue of year-of-sale depreciation as is involved here; but the broader issues before the Court in *Massey Motors* and *Evans* necessarily included the narrower one involved here, and the opinion of the Court on the broader issue concerning the nature of the reasonable allowance for depreciation and the accounting therefor has affirmed principles which, we submit, are completely at odds with a general rule of law requiring an automatic disallowance of depreciation in the year of sale

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[19] In a companion case, *The Hertz Corp.* v. *United States*, 364 U.S. 122, the Government's brief (No. 283, Oct. Term. 1959, p.32 n.6 and p.40) quotes from *Cohn* only for the general proposition that depreciation must be based upon reasonable estimates of useful life in the business and of salvage value as of that time, and on page 50, n.27 it describes the holding thus: "It (the court) required that the taxpayers, who had reasonable notice that their assets had relatively high salvage value, adjust their depreciation deductions in the last years of useful life to take account of that factor. Taxpayers in that case had not deducted any salvage value in the first instance (though they were operating under the straight line method) and the court appropriately held that no further depreciation deductions were allowable after the assets had been depreciated down to reasonable salvage value."

geared to selling price, as opposed to reasonably estimated salvage value.

Neither panel of the court below, either in this case or in the *Motorlease* case, saw fit even to mention this Court's decision, let alone to discuss or analyze it. Instead, the court was of the opinion "that the Cohn case adequately supports the Commissioner's position", "though it could have been more explicit", 335 F.2d at 17. Circuit Judge Moore, on the other hand, in his dissent below, found support for the taxpayers in this Court's decision in *Massey Motors* and *Evans*, and he referred to the District Court's opinion in *Motorlease,* 215 F.Supp. 356 (D. Conn. 1963), as a "thorough and well reasoned analysis of the depreciation problem", 335 F.2d at 15. District Judge Blumenfeld, of course, relied heavily upon *Massey Motors* and *Evans* for his conclusions. See 215 F.Supp. at 359-361.[20]

Other courts have relied on *Massey Motors* and *Evans* in rejecting the Commissioner's general rule of law, which requires the disallowance of depreciation in the year of sale in every case where an asset is sold at a gain. *United States* v. *S & A Company,* 338 F.2d 629, 634, 640-641 (C.A. 8), now pending on petition for writ of certiorari, No. 50, this Term; *S & A Company*

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[20] Circuit Judge Moore, dissenting in *Fribourg Navigation,* expressed the view that, in any event, the *Motorlease* case was wrongly decided by the other panel of the court. "Motorlease as decided by this court in substance and actuality goes contrary to the decisions of the Supreme Court in Massey and Evans". * * * Motorlease was analagous to, and should have been controlled by, Massey, Evans, and Hertz. Yet there is no consideration of, or even mention of, those important cases or the legal principles declared therein". 335 F.2d at 21.

v. *United States,* 218 F.Supp. 677, 680, 682 (D. Minn. 1963); *Macabe Company, Inc. et al* v. *Commissioner* 42 T.C. 1105, 1112-1115; *Holder Drive-Ur-Self, Inc.* v. *Commissioner,* 43 T.C. 202, 208; see *Wyoming Builders, Inc.* v. *United States,* 227 F.Supp. 534, 538 (D. Wyo. 1964), pending on appeal to the Tenth Circuit; *Occidental Loan Company* v. *United States,* 235 F. Supp. 519, 524-525 (S.D. Cal. 1964).

In any event, the Commissioner's rule has not met with success in the courts. Apart from the decisions of the panels of the court below in this case and in the *Motorlease* case, and a decision of the United States District Court for the Eastern District of Tennessee (*Killebrew* v. *United States,* 14 AFTR 2d 5545 (E.D. Tenn. 1964), every court which has now specifically considered the Commissioner's contention has rejected it. *United States* v. *S & A Company,* 338 F.2d 629 (C.A. 8), now pending on petition for writ of certiorari, No. 50, This Term; *S & A Company* v. *United States,* 218 F.Supp. 677 (D. Minn. 1963); *Wyoming Builders, Inc.* v. *United States,* 227 F.Supp. 534 (D. Wyo. 1964), pending on appeal to the Tenth Circuit; *The Motorlease Corp.* v. *United States,* 215 F.Supp. 356 (D. Conn. 1963); *Occidental Loan Co.* v. *United States,* 235 F.Supp. 519 (S.D. Cal. 1964); *Kimball Gas Products Co.* v. *United States,* 63-2 U.S.T.C. Par. 9507 (W.D. Tex. 1962), pending on appeal to the Fifth Circuit; *Macabe Company, Inc.* v. *Commissioner,* 42 T.C. 1105; *C. L. Nichols et al* v. *Commissioner,* 43 T.C. 135; *Harry Trotz* v. *Commissioner,* 43 T.C. 127; *Moses Lake Homes, Inc.* v. *Commissioner,* T.C. Memo, 1964-289; *Palmaneda Adams* v. *Commissioner,* T.C. Memo, 1964-286; *Holder Driv-Ur-Self, Inc.* v. *Commissioner,* 43 T.C. 202; *Harry Friend* v. *Commissioner,* T.C.

Memo, 1965-35; cf. *Melvon Miller* v. *Commissioner,* T.C. Memo, 1964-305; *Smith Leasing Co.* v. *Commissioner,* 43 T.C. 37; *Bell Lines, Inc.* v. *Commissioner,* 43 T.C. 358; *The Covered Wagons, Inc.* v. *Commissioner,* T.C. Memo, 1965-79. See also *Forrester Box Co.* v. *Commissioner,* 123 F.2d 225, 229 (C.A. 8).

Indeed, after its decision in favor of the Commissioner in this very case had been affirmed by the court below, the Tax Court, in the *Macabe* case, *supra,* refused nevertheless to follow the decision of the court below, stating specifically that it disagreed with its rationale (42 T.C. at 1110),[21] and the Tax Court, in all subsequent decisions, has rejected the Commissioner's contention for a general rule of disallowance of depreciation in the year of sale at a gain. See cases cited *supra,* pp. 34-35.[22]

The decision of the Sixth Circuit in *Cohn* v. *United States,* 259 F.2d 371 (C.A. 6), which the Commissioner has relied on so heavily in support of his rule (see e.g. Rev. Rul. 62-92, 1962-1 Cum. Bull. 29) and which the court below thought "adequately supports the Commissioner's position" (335 F.2d at 17), has not persuaded the other courts. It has either been distinguished on its facts, or it has been criticized as wrong-

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[21] The Tax Court stated, however, that it agreed with the *results* reached in the two cases below. We respectfully submit that the Tax Court's agreement with the results was based upon an apparent misunderstanding of the facts in the case. As to *Motorlease,* the details are set forth in footnote 24, p. 19 of the petition for a writ of certiorari in that case (No. 24, This Term), to which the Court is respectfully referred.

[22] Cf. the earlier Tax Court decision in *Rouse* v. *Commissioner,* 29 T.C. 70, which was, in effect, overruled by *Macabe,* 42 T.C. at 1116.

ly decided. See cases cited *supra*, pp. 33-35. And the writers have accorded the *Cohn* decision and the year-of-sale disallowance rule the same treatment as the courts. See Comment, *Disallowance of Depreciation in Year of Sale,* 50 Va. L. Rev. 1431; Note, 41 Ore. L. Rev. 159; Note 49 Cornell L.Q. 325; Note, VI Boston College Industrial and Commercial L.Rev. 631; Comment, 67 W.Va. L.Rev. 166; Note 33 Fordham L.Rev. 525; Note, 53 Georgetown L.J. 831; Horvitz, *Although CA2 upholds IRS on year-of-sale depreciation, Cohn rule may help taxpayers,* 21 Jour. of Taxation 203; Merritt, *Government Briefs in Cohn refute IRS disallowance of year-of-sale depreciation*, 20 Jour. of Taxation 156; Horvitz, *Sections 1250 and 1245: The Puddle and the Lake,* 20 Tax L. Rev. 285; 3 Rabkin and Johnson, *Federal Income, Gift and Estate Taxation,* § 43.14, p. 4397m; see also Smith, *Problems in the Disposal of Rental Property,* 13 Tax L.Rev. 331, 331-341; Walther, *Depreciation in the Year of Sale: Recent Developments,* 51 A.B.A.J. 281.

There is, thus, no support for the Commissioner's rule and the holding of the court below, either on principle or authority. The Commissioner having conceded the reasonableness of all of the factors making up the reasonable allowance for depreciation, it is plain then that there has been no conversion of ordinary income into capital gain by excessive depreciation allowances in either this case or the *Motorlease* case. The excess of the sales price of the assets over their adjusted basis reflects gains in value to be accounted for as such and taxed as such.

C. The Commissioner's Action Conflicts With Basic Accounting Principles.

We have argued above that if a taxpayer establishes a reasonable plan of depreciation for an asset used in the business, based on reasonable estimates of useful life and salvage value, as provided for in section 167 of the Internal Revenue Code of 1954 and the Commissioner's regulation thereunder, he is authorized, by the statute and regulations, to continue to take a depreciation deduction for such asset until the asset is disposed of or is no longer useful in the business, so long as the adjusted basis of the asset does not go below the estimated salvage value. And we have argued that the statute and regulations, properly construed, do not authorize the Commissioner to disallow a depreciation deduction, otherwise allowable for such asset during the year in which it is sold, merely because it was sold for more than its adjusted basis or book value.

This view of the statute and regulations does not establish new doctrine or new principles; it merely represents well-settled and long-established basic principles of depreciation accounting. And we shall show that the Commissioner's arbitrary rule is in conflict with these principles.

The accounting principles are clear. "Accounting for financial management and accounting for federal income tax purposes both focus on the need for an accurate determination of the net income from operations of a given business for a fiscal period". *Massey Motors, Inc.* v. *United States,* 364 U.S. 92, 106. In determining periodic net income, the costs involved in producing the income must be taken into consideration (*United States* v. *Ludey,* 274 U.S. 295, 304), and among those costs is the cost of the use of capital assets

devoted to the business. *United States* v. *S & A Company,* 338 F.2d 629, 639-640 (C.A. 8). It is the purpose of depreciation accounting, as we have already noted, "to make a meaningful allocation of this cost to the tax periods benefited by the use of the asset." (*Massey Motors, Inc.* v. *United States,* 364 U.S. 92, 96), "to distribute equitably throughout the several years of service life * * * the known cost less the estimated salvage value" (Mr. Justice Brandeis, dissenting in *United Railways & Electric Co.* v. *West,* 280 U.S. 234, 264).

Although the depreciation allowance has been defined in a variety of terms by the writers, "In all of these statements the essential conception is that of assigning the cost of the property to the accounting periods included in the useful life" (Paton, *Accountant's Handbook*, (3rd ed. 1947), p. 711),[23] and it is accepted

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[23] Some of the definitions of depreciation set forth in Paton, *supra,* p. 711, follow: "According to Montgomery (Auditing Theory and Practice) depreciation is 'an allocation of the entire cost of depreciable assets to the operating expenses of a series of fiscal periods'. Mason, (Principles of Public Utility Depreciation, American Accounting Association) states that 'depreciation is the expiration or disappearance of capital investment from the time of putting the asset into use until the time of its retirement from service'. J. B. Bailey (Journal of Accountancy, vol. 74) describes depreciation as 'the accounting for the consumption of the wasting of invested capital'."

See also the definition of depreciation by The Committee on Terminology of the American Institute of Certified Accountants, set forth in *Accountant's Encyclopedia,* (Prentice Hall, 1962) v.1, pp. 175-176: "*Depreciation* accounting is a system of accounting that aims to distribute the cost or other basic value of tangible capital assets over the estimated useful life of the unit * * * in a systematic and rational manner. It is a process of allocation, not valuation. Depreciation for the year is the portion of the

accounting practice to allocate the cost less the estimated salvage value of an asset over the entire period[24] of its estimated useful life in the taxpayer's business. In his 1923 edition of *Depreciation Principles and Applications,* Saliers wrote (p. 232): "If, as is not unlikely to be the case, an error is made in estimating the proper rate to be used owing to the impossibility of forecasting with great accuracy the useful life of an asset, it will be found that, when the property is abandoned or scrapped, the sum written off plus salvage value will not equal original cost. If too little has been written off the difference should be taken as a loss in the year in which the property is scrapped and should be deducted in that year for income tax purposes. If too much has been written off the excess should be reported as income in the year in which the residual value of the property is realized. This is equivalent to the realization of a larger salvage value than was anticipated." The fact that the market value of an asset may have appreciated during the period of its use

total charge under such a system that is allocated to the year. The concept that depreciation is an allocation of the cost of an asset over its service life is an application of the principle of matching costs against revenues. Each period that obtains the beneficial use of an asset is charged with an equitable share of its total cost less salvage value." See also Grant and Norton, *Depreciation* (1955) p. 34; Reynolds, *An Analysis of Depreciation Methods and Bases* (School of Business Administration, Univ. of North Carolina, 1962.)

[24] Saliers, *Depreciation Principles and Applications* (3rd ed. 1939) p. 160 (The "factors necessary to the composition of the current accounting period's depreciation charge are (a) original cost, (b) estimated life, and (c) estimated salvage value."); Finney and Mitter, *Principles of Accounting, Intermediate,* (5th ed. 1960) p. 335. See Note, 67 W.Va. L.Rev. 166, Note, 41 Ore. L.Rev. 159, 168.

resulting in a gain on the disposition of an asset does not, as a matter of accounting practice, exclude the year of sale from the period of use for which depreciation is allowable. Accountant's Encyclopedia, *supra,* vol. 1, pp. 175-176; Finney and Mitter, *supra,* p. 355; Saliers, *supra* (1939 ed) p. 100; Saliers, *supra* (1923 ed), pp. 50, 233; Grant and Norton, *Depreciation* (1955) pp. 34, 38. Indeed to consider market appreciation in value as offsetting depreciation is deemed an "impropriety" as a matter of accounting practice, Paton, *supra,* pp. 717, 718, 780.[25]

These well settled accounting principles were incorporated into the earliest published decisions of the Board of Tax Appeals over forty years ago which held that a depreciation deduction for property used in the taxpayer's business should be taken until the time the property was sold in order to arrive at the basis of the property for the purpose of determining the gain on disposition.[26] There was not the slightest suggestion that a depreciation deduction could not be taken in the year of sale if to do so would reduce the adjusted basis below the selling price. Indeed, it was the Commis-

[25] "The gains and losses on disposal are, in some degree, a correction of prior-period depreciation. However, since the element cannot be isolated, the full difference between the disposal price and book value is treated as a gain or loss for the period of retirement". Accountant's Encyclopedia, *supra,* vol. 1, p. 188.

[26] See e.g., *Even Realty Co.,* 1 B.T.A. 355; *W. W. Carter,* 1 B.T.A. 849; *Grosvenor Atterbury,* 1 B.T.A. 169; *Star Sporting Goods Co.,* 1 B.T.A. 1266; *Keighly Manufacturing Co.,* 2 B.T.A. 10; *Marchetta Roma Cafe Co.,* 2 B.T.A. 529; *Walter Frank,* 2 B.T.A. 905; *Cotton Concentration Co.,* 4 B.T.A. 121; *Capital City Investment Co.,* 4 B.T.A. 933; see *Union Metal Manufacturing Co.,* 1 B.T.A. 395, 398.

sioner who pressed the position that depreciation must be taken to the date of sale in order to establish the true gain realized on the sale of the asset.[27] And, in 1927, in *United States* v. *Ludey,* 274 U.S. 295, this Court held that in determining the gain realized on the sale of depreciable property, depreciation must be deducted to the date of the sale and the basis of the property adjusted accordingly. See also *Rieck* v. *Heiner,* 25 F.2d 453, 454 (C.A. 3), cert. den. 277 U.S. 608; *Forrester Box Co.* v. *Commissioner,* 123 F.2d 225, 229 (C.A. 8). "This accounting system has had the approval of this Court since *United States* v. *Ludey.*"

[27] In *Even Realty Co.,* 1 B.T.A. 355, the Board of Tax Appeals stated (pp. 361-362): "There is no reason why wear and tear, purely intrinsic matters, need be tied up to appreciation resulting from extrinsic causes. The two can go on simultaneously and no provision of law requires one to be offset against the other. The revenue acts do not contemplate the annual computation of appreciation for the purpose of taxing the increase of value thereby—they expect appreciation to be accounted for at the final disposition of the property. * * * Machinery and buildings do not gain in value, like cheese or wine, merely through lapse of time, nor do they improve with use." Compare this statement with the recent statement of the Tax Court in *Macabe Company, Inc.* v. *United States,* 42 T.C. 1105, 1109: "We find merit in petitioner's argument that the granting of a reasonable allowance for depreciation is a matter separate and distinct from the computation of gain upon the sale of property formerly held in the taxpayer's trade or business or for the production of income. The concepts of depreciation through the process of exhaustion, on the one hand, and of appreciation or depreciation because of market conditions, on the other hand, are mutually exclusive."

Massey Motors, Inc. v. *United States*, 364 U.S. 92, 104.[28]

The Commissioner attempts to discount these early decisions by asserting that the Commissioner has the right to change his interpretation where he believes it warranted, Cf. *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180. This may be so. But we refer to these early cases, not as binding precedents on the precise issue here involved, but as representing the long-existing and common understanding of the nature of the depreciation allowance and its relationship to the gain realized on the sale of a depreciable asset, and it is apparent that the Commissioner's arbitrary general rule of excluding depreciation in the year of sale at a gain is in the teeth of the accepted and long-established principles of depreciation accounting. Cf. *Duncan-Homer Realty Co.*, 6 B.T.A. 730.

The Commissioner's theory arbitrarily excludes the last year of use of an asset from the period of depreciation despite the fact that the asset is concededly in use during that year in the taxpayer's business, and notwithstanding that during that year it contributes to the receipt of income and its use constitutes a legitimate cost incurred in the production of income just as

[28] The opinion in *United States* v. *S & A Company*, 338 F.2d 629, 636-637, (C.A. 8) refers to additional cases allowing depreciation during the year of favorable sale and to "a series of administrative procurements in which depreciation to the date of sale seems consistently to have been recognized." Cf. *Thomas Goggan & Bro.*, 45 B.T.A. 218, where the Board of Tax Appeals refused to allow additional depreciation during the year in which an asset was traded and the trade-in allowance was less than the depreciated basis, on the ground that the trade-in allowance could not determine the amount or rate of depreciation to be allowed.

in the years prior to the year of sale. Not only does this violate the basic principle that depreciation accounting is intended to make a meaningful allocation of the cost of the use of an asset to all of the periods to which it contributes, but it violates the Commissioner's own regulation, as already noted, requiring that "the period for depreciation of an asset shall begin when an asset is placed in service and shall end when the asset is retired from service". Section 1.167(a)-10(b). Further, the Commissioner's position that the "depreciation disallowance should be limited to the year in which an asset is sold for more than its adjusted basis" (*Fribourg Navigation Co.* v. *Commissioner,* 335 F.2d 15, 16, 20) has the double effect of overstating income for the year of sale and understating income during prior years—a distortion that conflicts with proper accounting practices and which results solely from the Commissioner's attempt to equate a known sales price with estimated salvage value.[29]

The Commissioner's position would have the effect of making the accounting for depreciation depend upon wholly artificial and unrealistic circumstances,

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[29] Reference to the accelerated depreciation provisions of section 167(b) and 167(c) of the Internal Revenue Code does not support the Commissioner's theory. To be sure, they authorize larger depreciation deductions in the earlier years of an asset's use. But even under those provisions, the limit of the depreciation allowance is the estimate of "reasonable salvage value" and not the resale price (Section 1.167(a)-1(a)). Moreover, and in any event, the extent to which the earlier years of an asset's use may permissibly bear a higher deduction for depreciation than the later years is authorized by the specific statutory provisions enacted for economic purposes to encourage investment in plant and equipment by permitting a speedier return of capital outlay than would normally be permissible.

and, indeed, would create such a preoccupation with tax consequences as to invite wholly abnormal business practices. For example, a taxpayer can avoid the effect of the Commissioner's rule by holding an asset until a few days after the close of his tax year and then selling it. This is so, because, as already noted, under the Commissioner's position, depreciation is not disturbed for the years prior to the year of sale. In this case and in the *Motorlease* case, every penny of disallowed depreciation could, on the Commissioner's theory, legitimately have been retained by the taxpayers if the assets had been held until a few days into new tax years and then sold. In the *Fribourg* case, the taxpayer disposed of the vessel on December 23, 1957, and the Commissioner disallowed all depreciation claimed during all of 1957. If the vessel had been held for a very short period more, until a few days into January of 1958, apparently, under the Commissioner's theory, depreciation for the entire year of 1957 would have been permissible and allowed.

We suggest that it is absurd to assert, on the one hand, that the vessel had declined in value for depreciation purposes in 1957 because it was not sold until a few days into 1958, and to assert, on the other hand, that it had not declined at all in value for depreciation purposes in 1957 because it was sold a few days before the end of 1957. We suggest that it is absurd to assert, in one case, that the use of the vessel constituted a cost of doing business in 1957 and that, in other, its use did not represent a cost at all in 1957.[30] We sug-

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[30] The Commissioner's year-of-sale theory has implicit in it the notion of *scienter*—a taxpayer is not entitled to a deduction when he *knows* that the asset has not diminished in value, which is the situation, in the Commissioner's view, only after the sale.

gest, further, that it is absurd to assert that, in the one case, the use of the vessel contributed to the receipt of income in 1957 and that, in the other, the use of the vessel made no contribution at all to the receipt of income in 1957. And, finally, we suggest that the Commissioner's theory cannot "further the integrity of periodic income statements" (*Massey Motors Inc.* v. *United States,* 364 U.S. 92, 104) when the amount of income to be reported can be so readily altered by such artificial factors.

The Commissioner's theory invites abuse of the depreciation concept, and it penalizes the meticulously careful taxpayer.[31] Since capital gains developed in the years prior to the year of sale will not be affected under the Commissioner's theory, there is every incentive for a taxpayer to estimate salvage value as small as possible, within the area of reasonableness, thereby increasing the periodic depreciation deduction and reducing the adjusted basis of the asset in the years prior to the year of sale and creating the capital gain which the Commissioner concedes may be retained. A more strained and perverse interpretation of sound depreciation practice is difficult to imagine.

It seems quite clear to us why the Commissioner espouses a theory which involves such absurdities. If,

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But, if toward the end of a tax year, a taxpayer intended to dispose of an asset which had a large rise in value—as in this case—but did not actually sell it until early in the following year, it defies credulity to assert that the deduction in the year prior to the sale year was taken any less *knowingly* than in the year of sale.

[31] See 21 Journal of Taxation 203, 205: The Commissioner's rule "works most harshly against those taxpayers who are least guilty of over-depreciations. The rule works in favor of those who depreciate under a fast write-off method."

as the Commissioner argues, the taxpayer's estimates are no longer relevant after an asset is disposed of, and the actual selling price is to determine the limit of the depreciation allowance, then the necessary logical conclusion is that *any* depreciation which reduces the basis below the selling price must be disallowed. This, of course, would result in the effective repeal of section 1231 of the Code and the Commissioner's own regulations providing for the tax treatment of gains on disposition as capital gains. In an effort to avoid being accused of administratively repealing section 1231, and in order to give some limited meaning and effect to that section, the Commissioner has, apparently, developed the notion of disallowing the deduction only during the year of sale, which is, we submit, a completely tortured view of the meaning of section 1231 and is without support either in the history of the statute or in the regulations providing for its administration.

We do not suggest that Commissioner must accept or allow all depreciation plans adopted by all taxpayers and that he is without authority to disallow excessive or unjustified claims based upon unreasonable estimates. We concede this authority in the Commissioner, and we contend that his proper functions and concern are with the reasonableness of the estimates and the resulting allowances. If, for example, the Commissioner is of the opinion that depreciation has been claimed in unrealistic amounts (cf. *Massey Motors, Inc.* v. *United States,* 364 U.S. 92) or on an unauthorized double-declining balance basis (cf. *Hertz Corp.* v. *United States,* 364 U.S. 122), he has ample authority to disallow them and insist that they be appropriately adjusted, and, under the Commissioner's

own regulations (section 1.167(b)-(O)(a), "it is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed." He is not limited to adjusting only the year-of-sale deduction. He is authorized, we contend, to disallow what he deems to be an unreasonable plan and require the adoption of a reasonable one, spread over the useful life of the asset in the taxpayer's business to the extent that the tax years are open, as the statute, the regulations, and sound accounting principles require. He cannot, however, arbitrarily disallow legitimate depreciation deductions during the final year solely because the asset was disposed of for more than its reasonably estimated salvage value.

We must emphasize that the burden on taxpayers to adopt reasonable depreciation plans is not a light one. It is not a simple matter to make a reasonable estimate in advance of what an asset will sell for when it is disposed of after use for an estimated period of time in a taxpayer's business. The normal difficulty is compounded for taxpayers like that in the *Motorlease* case who dispose of assets long before their value deteriorates to scrap. As we have already pointed out (*supra*, pp. 22-23, n. 13), the members of the American Automotive Leasing Association have incurred very large and substantial expenses in meeting the obligations which they believe the Commissioner's regulations put on them to make reasonable estimates. But the Commissioner, in total disregard of the obligation put on him to consider the reasonableness of a taxpayer's estimates, has adopted the arbitrary rule of automatic year-of-sale disallowance, casting aside the taxpayer's efforts as no longer relevant. This type of administrative response to a conscientious effort eliminates any

incentive upon the part of taxpayers to undertake the difficult and expensive and burdensome task of making really careful estimates in the first place. If the Commissioner's action represents proper practice, then the least informed guess is as good as a carefully considered estimate, just so long as too large a capital gain is not developed in years prior to the year of sale. We respectfully submit that both the taxpayer and the Commissioner have real obligations in the field of depreciation accounting and that the Commissioner cannot shirk his obligation by merely disregarding, as moot and irrelevant after the sale of an asset, what the taxpayer has carefully done in carrying out his obligation.

D. The Commissioner's Action Is Not In Accord With the Intent of the Congress.

We have shown, *supra*, p. 13, n. 5, that from the time of the enactment of the Special Corporate Excise Tax of August 5, 1909, 36 Stat. 113, the Congress has consistently defined the deduction for depreciation as a "reasonable allowance". And we have shown, further, *supra*, pp. 37 to 41, that, in the accounting for this "reasonable allowance" for depreciation, the year of sale was treated no differently than any other year and that it was well-accepted accounting practice, confirmed by the earliest decisions of Board of Tax Appeals and decisions of this Court, to take a depreciation deduction with respect to a depreciable asset for the entire period of its use up to the date of its sale, in order to determine the gain realized or loss sustained upon the sale of the asset.

In 1942, without in any way changing the definition of the reasonable allowance for depreciation contained

in section 23(l) of the Internal Revenue Code of 1939, and without any reference whatsoever to year-of-sale or actual selling price, the Congress added section 117(j) to the 1939 Code (Section 115(b) of the Revenue Act of 1942) which provided that gains realized upon the sale of depreciable assets used in the business for more than six months were to be taxable at capital gains rates only. This is now section 1231 of the Internal Revenue Code of 1954. As stated, there is nothing in this legislation or in its history to suggest, as the Commissioner now contends, that only the gains developed by depreciation deductions taken in the years prior to the year-of-sale were within the scope of the statute, that is to say, that no gain might be developed during the year of sale. The House Report, after noting that gains from the sale of depreciable property had been treated as ordinary income, stated (H.Rep. No. 2333, 77th Cong. 2d Sess. p. 15): "It appears that many taxpayers are able to dispose of their depreciable property at a gain over depreciated cost. To treat such gain as an ordinary gain will result in undue hardship to the taxpayer."

In 1947, the Treasury Department, in a report to the Congress commenting on a proposal to provide for accelerated depreciation, particularly for small business,[32] warned that accelerated depreciation allowances might enable a business man to convert ordinary income into capital gains by selling a fully depreciated asset that still had a substantial value and paying only a capital gains tax on the gain. This revenue loss could be avoided, the Treasury urged, by making the gain,

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[32] Hearings before the House Committee on Ways and Means, 80th Cong. 1st Sess, on Proposed Revisions of the Internal Revenue Code, Part V, p. 3756.

to the extent of the excess over normal depreciation, subject to tax as ordinary income. The proposal was not enacted, but, again, there was no suggestion that the Congress believed it was dealing only with those revenue losses that would result from gains that might be developed by depreciation deductions prior to the year of sale. On the contrary, it is quite clear that the Congress considered the problem in the light of revenue losses resulting from the sale of *fully depreciated* assets at a gain.

Likewise, in the course of its deliberations in connection with the development of the Revenue Act of 1950, the Congress again dealt with the capital gains provisions of section 117(j). Although the House Committee on Ways and Means proposed that *losses* on sales of section 117(j) property be treated as capital instead of ordinary losses (see H.Rep. No. 2319, 81st Cong., 1st Sess., p. 45), the Senate Finance Committee refused to go along with the suggestion (see S.Rep. No. 2375, 81st Cong. 2d Sess, pp. 51-52) and the proposal was rejected, as was the proposal to tax *gains* on the disposal of 117(j) assets as ordinary income. This latter proposal was rejected because it presented "serious difficulties" and would cancel out the beneficial results intended by the adoption of section 117(j) at a time when it was important that assets "get into the hands of those who will put them to most effective use". 96 Cong. Rec. 14057. The Congress, however, did enact in the Revenue Act of 1950 a provision for special five year amortization of certain certified national emergency facilities (section 216(a) of the Revenue Act of 1950, adding section 124A of the Internal Revenue Code of 1939) and amended section 117 to provide that any gains realized from the sale of

such facilities should be treated as ordinary income to the extent that deductions for such amortization exceeded the otherwise normally allowable depreciation deductions. Section 216(e) of the Revenue Act of 1950, adding sections 117(g)(3) of the Internal Revenue Code of 1939. In explaining how these provisions would operate, the Conference Report set forth examples disclosing clearly the Congressional understanding that depreciation not only could and should be taken to the date of sale in the year of sale, but also that such depreciation could create, in the year of sale, a gain to be taxed at capital gain rates, except to the extent that the special amortization deductions exceeded the otherwise normal depreciation deductions. See H. Rept No. 3124, 81st Cong., 2d Sess. p. 29.[33]

When the Revenue Act of 1951 was being considered by the Congress, it had before it a warning from the Treasury Department concerning a practice which had developed whereby a depreciable asset would be sold at a gain to a controlled corporation, the seller would pay only capital gains rates on the profits, and the buyer would have an increased basis for future depreciation deductions against ordinary income. H.Rep. No. 586, 82nd Cong., 1st Sess, p. 26. This abuse was corrected by the addition of a provision denying the capital gains treatment in connection with sales to various related taxpayers. Section 328(a) of the Revenue Act of 1951, adding sections 117(o) of the Internal Revenue Code of 1939. This was the only limitation engrafted upon the capital gain treatment of gains realized upon sale of depreciable assets, and there

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[33] See also these same examples which are still set forth in the Treasury Regulations, section 1.1238-1, Examples (1) and (2).

was no suggestion that gains were to be either eliminated or reduced by the disallowance of depreciation otherwise allowable during the year of sale.

In the Internal Revenue Code of 1954, the Congress provided for a variety of methods of accelerated depreciation (sections 167(b)(2), (3), (4)) and re-enacted section 117(j) of the 1939 Code without substantive change (Section 1231 of the Internal Revenue Code of 1954; see H.Rep. No. 1337, 83d Cong., 2d Sess, p. A275) even though it had before it recommendations to treat the gain on the sale of depreciable assets as ordinary income (Hearings Before Senate Committee on Finance, 83d Cong., 2d Sess, on H.R. 8300, p. 1324) and even though it was understood that the new methods would add to already existing tax advantages. 100 Cong. Rec. 3678.

In a letter to the Congress, dated April 20, 1961, on the federal tax system, the President recommended that the capital gains treatment be withdrawn from gains on the disposition of depreciable property, both personal and real. He stated as follows:

> This situation arises because the statutory rate of depreciation may not coincide with the actual decline in the value of the asset. *While the taxpayer holds the property,* depreciation is taken as a deduction from ordinary income. Upon its resale, where the amount of depreciation allowable exceeds the decline in the actual value of the asset so that a gain occurs, this gain under present law is taxed at the preferential capital gains rate. The advantages resulting from this practice have been increased by the liberalization of depreciation rates.[34] (Italics supplied)

[34] Hearings before the House Committee on Ways and Means on the President's 1961 Tax Recommendations, H.Doc.No.140, 87th Cong. 1st Sess. v.1, p.13.

The Congress adopted the President's recommendation with respect to personal property by the addition in 1962 of a new section 1245 to the Internal Revenue Code of 1954, which treats as ordinary income the gain realized on the sale of depreciable personal property, during taxable years beginning after December 31, 1962, to the extent of depreciation taken after December 31, 1961. The House Report, in recommending enactment of the proposal, stated (H.Rep. No. 1447, 87th Cong. 2d Sess., pp. 66-67): "Wherever the depreciation deductions reduce the basis of the property faster than the actual decline in its value, then when it is sold there will be a gain. Under present law this gain is taxed as a capital gain, even though the deductions reduced ordinary income." See also S.Rep. 1881, 87th Cong., 2d Sess., p. 95. It would be difficult, we submit, to find a clearer statement of a Congressional understanding that actual resale price is not the limit of depreciation deductions, that such deductions may reduce the book value of an asset below its resale price, and that the gain resulting therefrom would be taxed at capital gains rates but for the addition of the new section 1245. Again, there was no indication whatsoever that what the Congress was concerned about was only the gains developed in the years prior to the year of sale of an asset or that depreciation, otherwise allowable, might not be allowable during the year of a profitable sale. Additionally, it must be emphasized that the provisions of section 1245 are not retroactive, and what the Commissioner here seeks to accomplish is to obtain a retroactive effect without statutory authorization.

Finally, by the addition in 1964 of section 1250 to the Internal Revenue Code of 1954, the Congress

removed the capital gains treatment with respect to real estate sold after December 31, 1963 to the extent of depreciation taken after that date if the property is held for one year or less,[35] or to the extent of the excess of such depreciation over straight line depreciation if the property is held for more than one year, but not more than 20 months, or to the extent of a percentage of such excess if the property is held for more than 20 months.[36]

We think that the course of the legislative activity, or inactivity, which we have just reviewed, discloses (1) that the Congress, until very recently, had no knowledge or information whatsoever of any doctrine or principle or decision requiring the disallowance of depreciation in the year of sale, (2) that, indeed, it had been warned time and again of revenue losses resulting from gains realized on the sale of depreciable assets, (3) that, on the basis of existing well-known principles

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[35] If the Commissioner's contention in this case were sound, or if the Congress had intended it to be the law, this provision would not have been necessary at all, because year-of-sale depreciation would not be allowable and there would be no capital gains to be taxed at any rate.

[36] In the Senate Report accompanying the bill which became the Revenue Act of 1954, adding said section 1250, the Senate Finance Committee referred—for the very first time, so far as we are aware—to a holding restricting a depreciation deduction in the year of sale. S.Rep. No. 830, 88th Cong. 2d Sess, p. 133. We think it most significant that during the entire period of time since the enactment of section 117(j) in 1942, this reference, in 1964, was the first reference, so far as we are aware, to the year-of-sale disallowance of depreciation, and the reference in the Senate report stated merely that "it has been held"; there is no statement of any established doctrine to that effect, or of any such accepted accounting principle.

and decisions, it believed that these revenue losses were the result of depreciation deductions which reduced the book value of an asset below its selling price and these included deductions taken during the year of sale, (4) that, notwithstanding all this, it refused, for many years, to amend the law at all, and (5) finally, when it did amend the law, it did so only gradually and on a piecemeal basis and without retroactive effect.

We think the Commissioner has attempted to accomplish by his ruling what the Congress had refused to do for so long a period of time. See *United States* v. *S & A Company*, 338 F.2d 629, 633 (C.A. 8); *The Motorlease Corp.* v. *United States*, 215 F.Supp. at 365-366; *Macabe Co., Inc.* v. *Commissioner*, 42 T.C. 1105, 1117-1118.[37]

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[37] The Commissioner may urge that this course of legislative conduct is immaterial and irrelevant because his ruling deals merely with the deduction for the year of sale, whereas the Congress was dealing with the broader question of eliminating the capital gains treatment entirely. This contention is beside the point. Apart from the fact that the Commissioner's ruling goes a long way toward eliminating capital gains, the fact is that the Congress was dealing with the broader problem of depreciation deductions for any year—including the year of sale—creating capital gains. The broad area of concern of the Congress included the more narrow area of the present activity of the Commissioner, and the Congress failed or refused to act until only just recently.

CONCLUSION

For the foregoing reasons, therefore, it is respectfully submitted that the judgment of the court below should be reversed.[38]

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[38] We submit also that, on the basis of the foregoing, the Court should grant the petition for a writ of certiorari in the *Motorlease* case and reverse the decision of the court below in that case without hearing.

APPENDIX

APPENDIX A

Internal Revenue Code of 1954:

Sec. 167. Depreciation.

(a) *General Rule.*—There shall be allowed a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

(b) *Use of Certain Methods and Rates.*—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations presented by the Secretary or his delegate, under any of the following methods:

(1) the straight line method,

(2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),

(3) the sum of the years-digits method, and

(4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2).

Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection (a).

(c) *Limitations on Use of Certain Methods and Rates.*—Paragraphs (2), (3), and (4) of subsection (b) shall apply only in the case of property (other than intangible property) described in subsection (a) with a useful life of 3 years or more—

* * * * *

(f) *Basis for Depreciation.*—The basis on which exhaustion, wear and tear and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

Treasury Regulations on Income Taxes (1954 Code):

SEC. 1.167(a)-1. *Depreciation in general.*—(a) *Reasonable allowance.* Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(f) and § 1.167(f)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) below for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) *Useful life.* For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over

which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. The period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1.

(c) *Salvage.* Salvage value is the amount (determined at the time of acquisition) which is estimated at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the deter-

mination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b), salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, § 1.167(b)-2(a) for the treatment of salvage under the declining balance method. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value see §§ 1.167(b)-1, 2, and 3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

* * * * *

SEC. 1.167(a)-8. Retirements—(a) *Gains and losses on retirements.* For the purposes of this section the

term "retirement" means the permanent withdrawal of depreciable property from use in the trade or business or in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. In addition, the asset may be withdrawn from such productive use without disposition as, for example, by being placed in a supplies or scrap account. The tax consequences of a retirement depend upon the form of the transaction, the reason therefor, the timing of the retirement, the estimated useful life used in computing depreciation, and whether the asset is accounted for in a separate or multiple asset account. Upon the retirement of assets, the rules in this section apply in determining whether gain or loss will be recognized, the amount of such gain or loss, and the basis for determining gain or loss:

(1) Where an asset is retired by sale at arm's length, recognition of gain or loss will be subject to the provisions of sections 1002, 1231, and other applicable provisions of law.

* * * * *

Sec. 1.167(a)-10. When depreciation deduction is allowable. (a) A taxpayer should deduct the proper depreciation allowance each year and may not increase his depreciation allowances in later years by reason of his failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line method if no allowance has ever been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section

167 (b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service.

* * * * *

Sec. 1.167(b)-0. Methods of computing depreciation.—(a) *In general.* Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Generally, depreciation deductions so claimed will be changed only where there is a clear and convincing basis for a change.

* * * * *

Sec. 1.167(b)-1. Straight line method.—(a) *Application of method.* Under the straight line method the cost or other bases of the property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the

property. The allowance for depreciation for the taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. For convenience, the allowance so determined may be reduced to a percentage or fraction. The straight line method may be used in determining a reasonable allowance for depreciation for any property which is subject to depreciation under section 167 and it shall be used in all cases where the taxpayer has not adopted a different acceptable method with respect to such property.

APPENDIX B

PERLMAN, BALDRIDGE, LYONS AND BROWNING
Suite 1021, Tower Building
14th and K Streets, Northwest
Washington 5, D. C.

December 10, 1955

The Commissioner of Internal Revenue
Internal Revenue Service
12th Street and Constitution Avenue,
Washington 25, D. C.

Attention: T. P.

Dear Mr. Commissioner:—

This letter is written to suggest certain modifications in the proposed regulations under section 167 of the Internal Revenue Code of 1954, pursuant to Notice of Proposed Rule Making appearing in the Federal Register of Friday, November 11, 1955 (20 F. R. 8454 et seq.) and entitled "Income Tax: Taxable Years Beginning after December 31, 1953; Depreciation."

This submission is on behalf of the American Automotive Leasing Association, an Illinois non-profit corporation

composed of companies engaged in the business of leasing automobiles to industrial and commercial companies on long-term leases, i.e., for periods of a year or more, some leases being for as long a period as two years. The lessor companies acquire their vehicles in fleets, and, when the vehicles are no longer suitable for leasing purposes, they are disposed of by the lessor companies in fleets at wholesale. The vehicles which these lessor companies lease do not constitute property held primarily for sale to customers in the ordinary course of trade or business. See Rev. Rul. 54-229; I.R.B. 1954-25.

During the period of the leases, the lessor companies supply the lessees with the car and its equipment, together with license plates and insurance against collision, fire and theft. The lessors also bear the cost of all mechanical repairs and maintenance, replacement of worn tires and tubes, lubrication and oil changes, repairs caused by accident, and also the cost of anti-freeze and tire chains, when necessary. The lessees' only expense is the monthly rental.

Our chief interest in the new proposed depreciation regulations may be briefly summarized as follows: It is our fear that the new regulations might be interpreted to require, as a matter of course and regular procedure in all cases, a recalculation of depreciation allowances taken in earlier years, even though the allowances, when taken, were based on reasonable estimates and resulted in essentially reasonable depreciations, such recalculation to be determined after the leased cars were sold and the actual amount of salvage realized would be known precisely. The recalculation would consist of subtracting the actual salvage realized from the cost of other basis and depreciating that net amount over the years the cars were in service. The reasons why those fears are very real will be shown in more detail below, but first I should like to set forth briefly what our present practice is in general and why the matter is of such great concern and importance to us.

It has been, and still is, the practice of most of these companies to depreciate their leased vehicles at a rate of about 2½% of cost a month, or about 30% a year. Not all companies use the precisely identical rate, but for the purposes of this letter it is fair to assume at this point a depreciation rate of 2½% of cost a month, or 30% a year. The use of this rate has resulted in some years, after the cars are disposed of at wholesale on resale, in a small profit per car over cost less depreciation taken; in other years, small losses per car have been sustained. Whether a profit has been made or a loss sustained has depended, of course, on the condition of the used car market at the time of sale. Profits have been taken as capital gains in the years realized and losses have been treated as losses in the years they were sustained. The results of the rate and method used have been approved in the past by the Internal Revenue Service, and, again for the purposes of this letter, it may be assumed that, depending on the condition of the used car market in future years, relatively small losses will be sustained or relatively small profits will be realized. It should be emphasized at this point that it is in no sense the purpose of this letter to urge that any particular rate or method of depreciation be approved for future use. It is realized that that is not appropriate here.

What our companies want here, and the sole purpose for which this letter is written, is assurance that they may continue the general practice which they have consistently used, and which they now use, of making a reasonable estimate of a depreciation allowance at the time their vehicles are put in service, of taking depreciation on that basis while the vehicles are useful in their business, and of treating, as a gain or loss in the year of resale, any small subsequent profit or loss that might result. The realization of such a profit or loss should not be the occasion to recalculate the depreciation over the years the vehicles were in service, where the over-all result has been reasonable.

While this problem is important to all taxpayers using depreciable property in their businesses, it is obvious that the problem is of particular importance with respect to companies engaged in the business of leasing automobiles. In most businesses, depreciable property is used merely in connection with the taxpayer's business, which usually has no direct relationship to the depreciable property—for example, the use of a cash register or a show case by a retail merchant. The depreciation rate of that register or show case, while important, is not of prime importance in the taxpayer's business. But in our business, dealing in the very property to be depreciated—i.e., the leasing of automobiles—constitutes the very essence and, indeed, the entire business of these companies. There is probably no other single factor in determining whether a profit has been made or a loss sustained more important than the allowable depreciation. Any retroactive changes in depreciation for these leased cars, when the original plan was reasonable when made, can very easily result in retroactively converting profitable years into losing years or retroactively giving rise to claims for more taxes—all this at a time when it is too late for the companies to refix their rental rates retroactively, and after those rates had been fixed on the assumption that the reasonable estimates for depreciation would stand. The possibility of such instability unquestionably affects the bank credit of these companies and throws their entire operations into serious jeopardy. It is because of this almost unique situation with respect to these companies and the very serious problem presented to them that this letter is being written.

While it is almost inconceivable that the proposed regulations on depreciation were intended to have the effect that I have suggested, the fear that they might be so interpreted is not without some justification. The new regulations define with great care the elements that go into making up the depreciation allowance, and the concepts of useful life

and salvage value are spelled out in detail. But when the regulations are read as a whole, one does not come away with the certain understanding that the depreciation allowance provided for in the regulations is what such an allowance always had been in the past—a reasonable estimate in advance, rather than a specific figure determined definitively after the fact. For example, in section 1.167(a)-1(c), salvage value is defined as the "amount realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is retired from service by the taxpayer." Such an amount seems to be a specific sum. In section 1.167(a)-1(a), the regulations, in describing the depreciation allowance, state that it is the amount to be set aside yearly in accordance with a plan "so that the aggregate of the amounts set aside, *plus the salvage value*, will, at the end of the estimated useful life of the depreciable property, equal the cost, etc." (Underscoring supplied). This conveys the impression that the depreciation allowance must return the cost less salvage determined with mathematical precision, after a sale. Again in section 1.167(b)-O(a), it is stated that "Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover unrecovered cost or other basis *less salvage* during the remaining useful life of the property." (Underscoring added). Again, it would seem that strict application of this rule would require a redetermination of *salvage* after the event, with the consequent recalculation of depreciation over the years it had been taken. The possibility of this of this interpretation is not entirely imaginary, particularly when the sentence last quoted is contrasted with the statement appearing as long ago as 1931 in Bulletin F (Income Tax, Depreciation and Obsolescence), p. 10: "In no instance may the total amount allowed be in excess of the amount represented by the difference between the cost

or other allowable basis *and the salvage value which reasonably may be expected to remain at the end of the useful life of the property in the trade or business.*" The identical rule appears in the Revised Bulletin F of 1942. Such a rule leaves no doubt that it is the reasonably estimated salvage that is controlling.

We are not alone in our fear that the proposed regulations might give rise to the new, even though unintended, rule which I have discussed. For example, Research Institute's Taxation Report of November 17, 1955, after stating that the new regulations "make drastic changes" and "take a far tougher view of salvage," makes the following observation:

> These new regulations would virtually bar any capital gains on disposition of depreciable property (other than breeding, dairy and draft animals which generally have a zero basis to start). If the sales price exceeded the depreciated basis, the Treasury could claim that the salvage value was equal to the sales price and reduce the depreciation deduction by the amount of the "gain."

The possibility of this interpretation has also been expressed in legal and accounting circles. While our group is not suggesting the adoption of a rule that will guarantee a capital gain which the above quotation states the proposed regulation would necessarily eliminate, we are greatly concerned, as already noted, about the adoption of a rule which will provide the instability that goes with any regular recalculations.

It is my understanding that the regulations were, in fact, not intended to have that result. Such a result would impute to the drafters a purpose to burden the Internal Revenue Service with an impossible administrative task and to harass a multitude of taxpayers with constant recalculation of their taxes.

Therefore, it is suggested that the following modifications be incorporated into the proposed regulations:

1. In the second sentence of section 1.167(a)-1(a) add the words "reasonably estimated" before the word "salvage," so that the sentence would read as follows:

> The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the *reasonably estimated* salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property, as provided in section 167(f) and § 1.167(f)-1.

2. In the third sentence of section 1.167(a)-1(a), substitute the words "reasonably estimated" for the word "reasonable" before the word "salvage" so that the sentence will read as follows:

> An asset shall not be depreciated below a *reasonably estimated* salvage value under any method of computing depreciation.

3. In the fourth sentence of section 1.167(b)-o-(a), add the words "the reasonably estimated" before the word "salvage" so that the sentence will read as follows:

> Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less *the reasonably estimated* salvage during the remaining useful life of the property.

* * * * * * * * * *

At this point I should like to call to your attention one other related matter which, I believe, can be remedied by the addition of one sentence to these regulations.

It is my understanding that a few of our companies have followed the practice of taking a larger depreciation during the first year of service of the vehicles than in the second. While this practice may be referred to as "accelerated" depreciation, or a declining balance method, it is, of course, not the statutory method referred to in section 167(b)(2) of the Internal Revenue Code. Where such a practice has resulted in a "reasonable allowance" and where it will continue to do so, it is, of course, the desire that there be no necessity for a change. It seems quite clear that it is the intent of the proposed regulations to authorize the continuation of such plans and methods which had previously produced reasonable depreciation allowances. That would seem to be the primary purpose of section 1.167(b)-o-(b) of the proposed regulations. But it is not entirely certain that the section completely accomplishes its purpose. For example, the section accepts "the declining balance method with the rate limited to 150 percent of the applicable straight line rate." It must necessarily have approved that method without regard to the limitations of section 167(c) of the Internal Revenue Code. But the limitations of section 167(c) are in turn applicable to the method set forth in section 167(b)(2) of the Code which refers to a declining balance method using a rate *not exceeding* twice the straight line rate; *thereby including a method using a 150% rate.* The regulations might, therefore, possibly be interpreted to require compliance with section 167(c) even for those previously using up to a 150% declining balance method. It seems to me that the regulations should make clear that the methods intended to be approved in section 1.167(b)-o-(b) of the regulations were approved without regard to the limitations of section 167(c) of the Code. This is important because there are open years for which such limitations could not have been complied with and for which the methods used must not be deemed to have been within section 167(b)(2). This

can be accomplished by inserting after the first sentence of section 1.167(b)-o-(b) the following sentence:

> The limitations of section 167(c) shall not be applicable to these methods.

* * * * * * * * * *

Very truly yours,

s/ Ellis Lyons
Ellis Lyons